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Alberta ECONOMIC OUTLOOK

NOVEMBER, 1974

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ALBERTA AND THE NOVEMBER 18th FEDERAL BUDGET

Provincial Tax Concession to Offset Budget Effect on Petroleum Producers

The Alberta Government has introduced legislation to assist petroleum companies to overcome the economic impasse created by the November 18 federal budget. In the form of lower crude oil and natural gas royalties and performance credits the government action, while providing assistance to the industry generally, is aimed at assisting the smaller producers who would suffer most under the provisions of the federal budget.

Highlights are:

*Refunds to oil companies from Alberta's share of federal corporation taxes paid on provincial royalties — amounting to about \$130 million in 1975.

*Reduced royalty rates on oil for that portion of the price above \$6.50 per barrel — the amount is yet to be negotiated.

*Raising the price above which higher royalties are charged from \$4.11 to \$4.71 per barrel. Dropping the effective royalty rates on old oil — discovered before January 1974 — from 40 to 36 per cent and on new oil from 28 to 27 per cent.

*Tax credits of up to \$1 million per company per year. This will offset all taxes paid on royalties for all but the 30 largest companies in Alberta and reduce to 25 per cent the effective royalty rate on old oil for small companies.

*Reduced royalty rates for natural gas from 65 to 50 per cent on that portion of prices above 72 cents per thousand cubic feet, to take effect in 1976, and estimated to cost the province about \$60 million yearly.

*Increased tax credits for exploration drilling, between 7 and 10 per cent, depending on the area drilled.

Events leading up to the provincial legislation went like this:

Alberta legislators and oil men were caught off-guard by the November 18 budget and the federal government's decision to increase the petroleum companies' federal tax burden.

Budget changes affecting the oil companies included:

*Automatic depletion to be replaced by earned depletion

Depletion to be permitted only up to 25 per cent of production profits

*Royalties and other like payments no longer tax deductible — especially rentals

*A 30 per cent rate of tax on oil and gas production profits declining to 25 per cent in 1976 — reduced from the pre-budget level of 50 per cent

*A 100 per cent write-off for exploration

*A 30 per cent write-off for development

Oil companies and legislators were most surprised by the imposed non-deductible status of provincial royalties.

Under the new system the \$6.50 price of a barrel of Alberta oil yields \$3.01 to the province, \$1.17 to the federal government, and \$1.72 to the industry with a final 60 cents charged to lifting costs.

The pre-budget industry share was \$2.75 per barrel. The industry is now faced with — according to these calculations — more than a dollar per barrel reduction in revenue.

As well, the federal government receives an additional \$5.20 export tax for every barrel of oil that leaves Canada.

The Independent Petroleum Association of Canada says the industry should receive \$4 per barrel if it is to meet future exploration commitments. They calculate that the effect of the current budget and inflation will reduce the real rate of return to about 75 cents per barrel. As a result companies are reluctant to commit themselves to further exploration.

The Canadian Petroleum Association estimated the value of Alberta exploration and development expenditures for 1975, prior to the budget, at about \$850 million. Post budget releases have caused project expenditures to be reduced to \$400 million down from last year's \$615 million.

The industry says the federal government's decision to collect income taxes on royalties is estimated to cost producers at least \$360 million annually.

They add that future exploration costs in the face of mounting inflation may go as high as \$40 billion in the next decade.

Alberta and the western provinces are competing with the U.S. "Project Independence" which has made oil exploration, south of the border, a more profitable proposition. (Gas price is regulated at 50 cents per thousand cubic feet for interstate purposes.)

The American scene may attract Alberta drilling companies for a number of reasons:

*"New" oil — defined as oil found after September 10, 1973 in the U.S. — sells for an average price of \$11.70 per barrel with an average royalty of 22 per cent. Lifting costs range from 10 cents to one dollar. This compares to the fixed price of \$6.50 per barrel in Alberta and an effective royalty rate of 28 per cent. Lifting costs are only slightly less in Alberta. However U.S. old oil sells for \$5.25 per barrel, accounting for 2/3 of marketed product.

*The U.S. oil may be marketed immediately.

*A quicker recovery of capital costs is available in the U.S.

*Shortages of materials (especially sucker pipe and valves) which have plagued Alberta operators have not been prevalent in the U.S. Shutdowns due to material shortages can therefore be avoided.

Fair Market Value

Another more subtle but perhaps far-reaching aspect of the budget is the fair market value condition, which states that regardless of the price a company receives when it sells petroleum or a petroleum derivative to a provincial marketing board or corporate affiliate, it will be taxed on what the federal government decides is fair market value.

For example:

A provincial crown corporation buys gas from a producer at 22 cents per thousand cubic feet and resells it to consuming companies for 57 cents per thousand cubic feet. Before the November budget, the federal government would receive tax on the 22 cents purchase price. Under the new provisions the producer will be taxed on the 57 cents — even though they received only 22 cents.

Lastly, the budget proposals — as they affect the industry — are retroactive to May 1974 — a condition which upset corporate confidence in federal legislators. Oil companies point out that the May legislation and the government were defeated. The November budget is not of the same government, the same parliament or the same legislation, therefore why impose May's conditions? However, the government was re-elected on a platform which included proposed budget changes.

The issue of resource taxation, while of importance to all provincial governments, is doubly important to Alberta. In essence the situation relates to the equitable distribution of wealth commensurate with the recent increases in resource prices.

Each group believes it has a legitimate claim to this wealth. Producers cite exploration and development costs; the federal government cites the maintenance of an adequate tax base; while the position of the Alberta government is based on the constitutional guarantee of provincial ownership and control of natural resources and that the benefits of these resources should accrue to the people of Alberta.

The federal government, has refuted the province's argument that taxation of provincial royalties is unconstitutional. The action, they say, is necessary to preserve a fair share of resource revenue for the federal government.

The Effects of the Federal Budget on Other Areas

The budget generally is aimed at placing more money in the hands of consumers. Savings and investments have also been stimulated. To this extent it can be described as a counter — recessionary budget.

Housing

The following items relating to housing have been incorporated in the budget:

*Reduction of federal sales tax from 11 to 5 per cent on building and construction materials.

*A \$500 new home buyer grant for "moderately priced" homes (\$30,000 to \$50,000)

*Registered home-ownership savings plan

*Non-deductability of interest and carrying charges on land

*High-ratio financing is no longer restricted to moderately priced housing

*Removal of sales tax from construction equipment.

The effects of these housing measures are not expected to be substantial, and residential construction will probably continue to lag.

Savings of \$1,000 to \$1,500 per home are expected due to the combined effects of the \$500 new home buyer grant, and the reduction of federal sales tax on building materials to 5 per cent (estimated to have an average \$650 per house effect). However, on a \$30,000 to \$40,000 home, this is not a substantial figure. The total effect of the federal budget's housing measures is slightly greater than a one-half per cent decrease in the mortgage interest rate.

Real estate and residential construction firms have already stated that these savings will be eroded by spring 1975 due to inflation. More money in consumer hands, plus the reduction of sales tax may rekindle home buying interest and thereby cause price escalation due to lack of significant federal government proposals to increase the supply of housing.

The effect of the registered home-ownership savings plan is likely to be minimal since the ten years needed to accumulate \$10,000 will likely see a greater price increase due to inflation. However the disallowance of deductions for interest and carrying charges on land will make land more expensive to hold and may therefore put more land on the market.

Personal Income and Savings

Personal income and savings will increase due to added budget incentives, including:

*Tax exemption on the first \$1,000 of interest income including dividends from Canadian corporations

*Registered home-ownership savings plan

*A 3 per cent reduction in personal income tax

Business

The budget measures dealing with business varied considerably. The two main provisions are:

*Extension of the two-year, rapid write-off provision for manufacturing and processing equipment.

*A 10 per cent surcharge on corporate income, earned from May 1, 1974 to April 30, 1975 except for manufacturing and processing firms.

Manufacturing and processing firms benefited from the above measures. While others naturally suffered from the 10 per cent surcharge on corporate income, manufacturing and processing firms still enjoy the preferential tax rate of 40 per cent. The two year rapid write-off is also a powerful incentive.

Easier equity financing for Canadian corporations may result from the new provision allowing for dividend income from Canadian corporations to be tax-free up to \$1,000. The effect may not be immediate, however, due to the current depressed state of the stock market.

It is also proposed to reduce the federal income tax on small corporations. Canadian-controlled private corporations will receive the benefit of a special 25 per cent rate on the first \$100,000 of annual business income (previously \$50,000). It is hoped that the reduction will encourage increased investment intentions among small businessmen.

As well, federal tax on a wide range of transportation equipment will be lifted immediately. Equipment affected includes railway cars, large trucks, buses carrying 12 or more passengers, cargo containers and all aircraft.

Sales tax on construction equipment and on materials used in municipal water distribution will be eliminated immediately.

The duty free entry for all types of aircraft and aircraft engines not made in Canada will be extended to June 1975.

Many of the budget proposals are of obvious benefit to Alberta. Among these are: The measures to improve the housing market, the move to increase competition brought about by tariff reductions, the removal of the federal sales tax on transportation equipment and municipal water distribution systems. The overriding significance of the resource taxation proposals however, combined with the effect on the Alberta economy brought about by the fiscal shift, make the budget on balance unfavorable to Alberta.

PERTINENT ECONOMIC INDICATORS FOR THE PROVINCE OF ALBERTA

Percentage Change in Volume Activity

INDICATOR	Total Year 1972 - 1971	Total Year 1973 - 1972	Year to Date 1974 - 1973
MANUFACTURING			
Slaughtered Meat Production	+ 3.3	- 2.2	- 9.7 (Jan. — Oct.)
Slaughtered Meat Exported	+ 5.3	- 0.6	- 4.9 (Jan. — Oct.)
Refinery Production	+21.4	+10.0	+10.0 (Jan. — Sept.)
Cement Production	+ 3.5	+ 7.8	- 1.1 (Jan. — Oct.)
MINING			
Oil Production	+20.8	+19.6	- 2.1 (Jan. — Sept.)
Gas Production	+16.8	+ 7.3	+ 1.0 (Jan. — Sept.)
Footage Drilled	+21.9	+28.3	- 4.9 (Jan. — Sept.)
Number of Wells Drilled	+13.1	+33.2	+43.7 (Jan. — Sept.)
Coal Production	+14.1	+ 0.4	+ 1.0 (Jan. — Sept.)
CONSTRUCTION			
Urban Dwelling Starts	- 15.4	- 7.2	- 15.8 (Jan. — Oct.)
Rigid Insulation Board Shipments to Alberta	+ 5.9	- 1.7	- 16.8 (Jan. — Oct.)
Value of Alberta Building Permits	+12.1	+20.0	+44.4 (Jan. — Oct.)
AGRICULTURE			
Grain Shipments	- 2.9	- 16.4	+ 1.5 (Jan. — Nov.)
Livestock Marketed	- 1.6	- 6.4	- 11.1 (Jan. — July)
Farm Cash Receipts	+14.0	+32.3	+47.7 (Jan. — Oct.)
FORESTRY			
Lumber Production	+16.0	+33.6	- 15.8 (Jan. — Oct.)
Lumber Sales	+ 5.7	+17.5	- 21.0 (Jan. — Oct.)
Lumber Exports	+24.7	+ 2.5	- 35.7 (Jan. — Oct.)
Pulpwood Production	+47.8	+46.6	+114.7 (Jan. — Oct.)

UNEMPLOYMENT RATE (unadjusted)	November 1974	October 1974	November 1973	October 1973
Canada	5.1%	4.4%	5.0%	4.6%
Alberta	2.0%	1.7%	4.0%	3.1%

CONSUMER PRICE INDEX (1961 = 100)

Calgary—Edmonton	163.4	161.4	145.9	145.1
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